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Pakistan: Balancing on a Foreign Payments Tightrope

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An Intelligence Assessment

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NESA 86-10028
May 1986
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Pakistan: Balancing on a Foreign Payments Tightrope [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted], Office of Near Eastern and South Asian Analysis. It was coordinated with the Directorate of Operations. Comments and queries are welcome and may be directed to the Chief, South Asia Division, NESA [redacted] 25X1
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Pakistan: Balancing on a Foreign Payments Tightrope [redacted] 25X1

Key Judgments

Information available as of 16 April 1986 was used in this report.

Islamabad is likely to face a growing foreign payments problem over the next five years. Because Pakistan has only a thin foreign exchange cushion, capital inflows from such sources as US aid, the International Monetary Fund, the World Bank, or Saudi Arabia would have to increase substantially from present levels to cover projected current account deficits. Without such help, Islamabad will have to institute austerity measures that have been associated elsewhere with a deterioration in domestic stability and a strengthening of antiregime forces. [redacted] 25X1

As Pakistan's foreign exchange situation deteriorates, Islamabad is likely to put increasing pressure on Washington to provide a bailout. If the United States is not sympathetic, the civilian government is likely to grow increasingly cool on issues of interest to Washington. For example, Islamabad could signal its displeasure by threatening to cut a deal with Moscow on Afghanistan in order to focus more on domestic economic problems or by backtracking on promised economic reforms. Islamabad is likely to blame Washington for the austerity measures it will have to impose. [redacted] 25X1

Pakistan's foreign payments—and its domestic financial position—will temporarily improve this year. New financial instruments and higher exports and remittances will strengthen Pakistan's foreign exchange position as well as increase its tax base and help control the budget deficit. This short-term improvement is likely to provide the new civilian government with an excuse to defer politically difficult policy changes it would like to avoid, such as currency devaluation, tax reform, and spending cuts. [redacted] 25X1

Over the next few years, however, we expect Pakistan's foreign payments position to worsen. Stiff international competition, low prices, and rising trade barriers are likely to hold down growth of Pakistan's export earnings near the low rates of recent years. Import growth will probably slow because of austerity measures and lower oil and commodity prices, but imports will still run almost twice the value of exports. We estimate that, if world oil prices remain at $15 a barrel over the next two years, Pakistan's remittance earnings could fall 56 percent from current levels. A continued fall in worker remittances and a rising debt burden will add to payments problems. [redacted] 25X1

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NESA 86-10028
May 1986

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Pakistan's deteriorating foreign payments position will force the civilian government to implement unpopular economic reforms and perhaps even cut imports. Such steps will enable the popular Bhutto-led Pakistan People's Party, freed from martial law constraints, to appeal to a powerful constituency of disfranchised groups—students, labor, urban poor, and small farmers—neglected under martial rule. The possibility for civilian unrest will increase if the number of Pakistani workers returning from jobs in the Middle East rises rapidly. [redacted] 25X1

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Contents

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Pakistan: Balancing on a Foreign Payments Tightrope

25X1

Because political instability in Pakistan has often been associated with poor economic performance, President Zia's martial law government worked hard to sustain economic growth. Pragmatic economic policies, generous foreign aid, high levels of worker remittances, and good weather have helped Pakistan sustain a more-than-6-percent real average annual growth rate since FY 1977.[1]

Robust domestic growth, however, has aggravated Pakistan's weak foreign payments position. Our analysis shows that for every 1-percent increase in GDP growth, import growth, in value terms, has increased by more than 1 percent. Imports have consistently far outstripped exports, leading to chronic trade deficits.

Dodging a Financial Bullet

Expansionary economic policies, a decline in worker remittances, and a disastrous cotton crop two years ago precipitated a serious foreign exchange crisis last summer. Rather than curb imports or slash government spending, Islamabad financed the rapidly growing current account deficit by drawing down reserves. From a high of $2 billion in December 1983, liquid reserves plummeted to roughly $325 million in mid-August 1985—equivalent to only three weeks' imports.

We believe that, since August, Zia's luck and creative financial maneuvering have enabled Pakistan to more than double its foreign exchange reserves, avoid going to the International Monetary Fund (IMF), and finance much of the public deficit. For example:

- Increased farm production stimulated a more-than-18-percent increase in exports—primarily raw cotton and cotton-based manufactures—while lower commodity prices helped the import bill drop about 1 percent in value terms compared with the first half of FY 1985, according to US Embassy reporting.

- Improved banking procedures that eased fund transfers and sums brought back by returning expatriate workers are likely to lead to a 3-percent rise in remittance earnings this year. 25X1

- Sales of Special National Fund Bonds (SNFBs) designed to tap the nation's large reserves of hidden assets have netted over $1 billion, more than five times the amount Islamabad expected.[2] Pakistani officials estimate the underground economy to be equivalent to at least 10 percent of GNP.

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- An estimated $500 million in sales of new high-interest Foreign Exchange Bearer Certificates (FEBCs) have helped Islamabad bolster its foreign exchange reserves, according to US Embassy reporting.[3] 25X1

Nevertheless, we expect the improvement in Pakistan's domestic finances and foreign payments position to be only temporary:
- Increased export earnings came in highly competitive areas—such as textiles and cotton—that are vulnerable to import quotas and declining world commodity prices.
- Remittances are likely to fall once the impact of lower oil prices reduces employment opportunities and wages of Pakistani workers in the Gulf states. 25X1

[1] The Pakistani fiscal year is from 1 July to 30 June. 25X1

[2] The SNFBs are special two-year bearer bonds that allow Pakistanis to launder hidden assets and avoid tax investigations. 25X1

[3] FEBCs are foreign currency certificates of deposit that pay high interest, are redeemable in foreign currencies, and allow purchasers confidentiality. These, we believe, have become particularly popular with narcotics traffickers, who use them to launder their foreign exchange earnings. 25X1

Figure 1
Pakistan: Foreign Payments Indicators

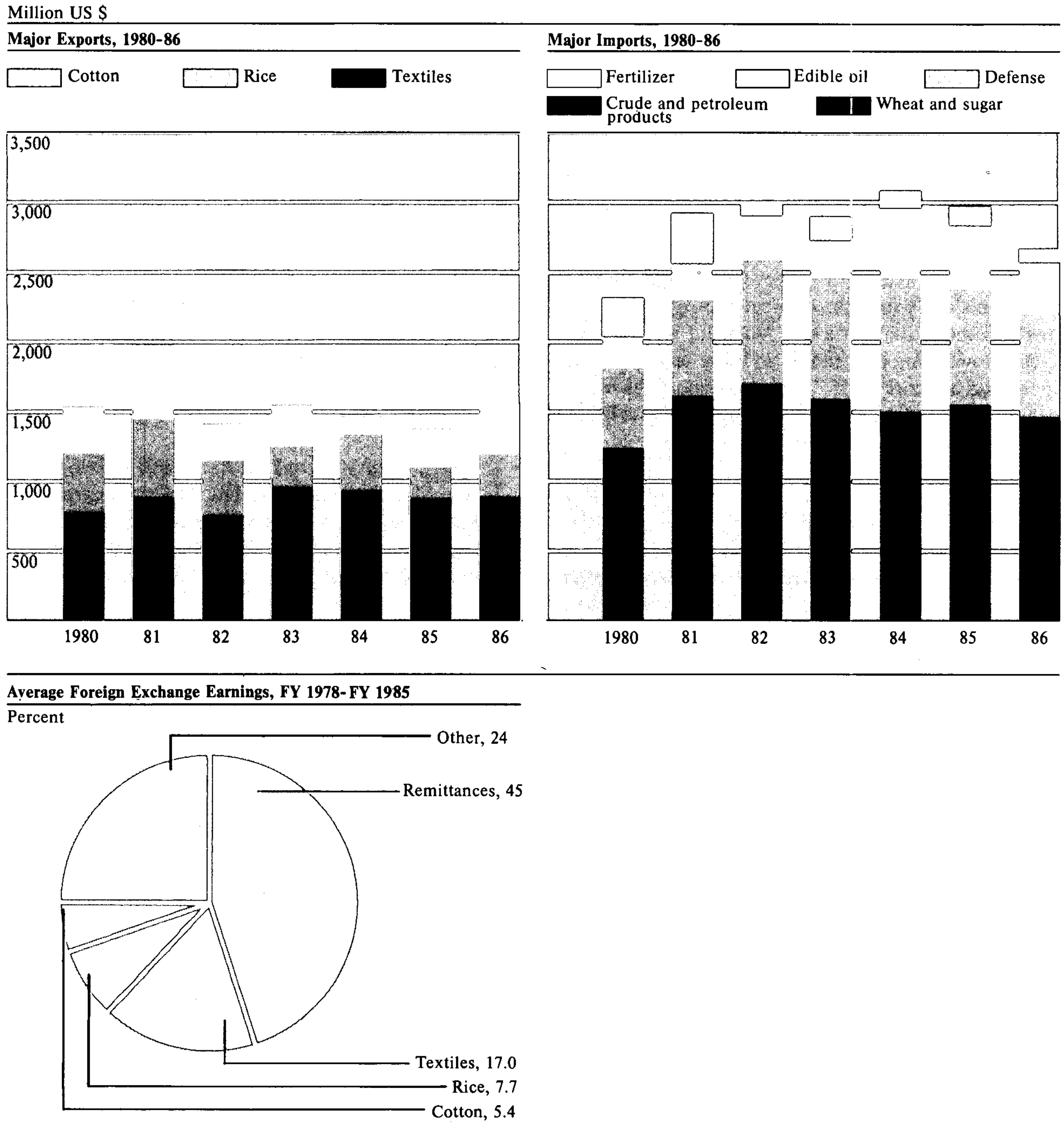

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Table 1
Pakistan: Foreign Payments, FY 1980–FY 1985 [a]

Million US $

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985
Trade balance	−2,516	−2,765	−3,450	−2,989	−3,324	−3,462
Exports (f.o.b.)	2,341	2,798	2,319	2,627	2,669	2,475
Imports (f.o.b.)	4,857	5,563	5,769	5,616	5,993	5,937
Services balance	1,219	1,639	1,677	2,274	2,020	1,624
Of which:						
Interest payments	285	357	453	421	477	461
Remittances	1,743	2,097	2,224	2,886	2,737	2,446
Private transfers	152	135	663	157	307	187
Current account	**−1,145**	**−991**	**−1,110**	**−558**	**−997**	**−1,651**
Government transfers	246	276	416	325	309	379
Long-term capital (net)	470	563	612	1,057	431	290
IMF		315	345	413		
Gross aid disbursements	808	680	676	976	925	850
Amortization (principal) payments	395	516	492	420	555	537
FMS payments [b]					28	66
Private capital	57	84	83	88	89	43
Other	147	443	−116	287	79	−105
Change in reserves	**−282**	**291**	**−198**	**1,111**	**−178**	**−1,087**

[a] Fiscal year beginning 1 July.
[b] Includes principal and interest.

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- Because the SNFBs are a one-time offer and must be repaid in two years, they will provide only short-term help and will add to Pakistan's domestic debt service burden.
- The high-interest FEBCs may lead to capital flight during periods of economic or political instability as purchasers claim their interest or cash in their certificates. [redacted]

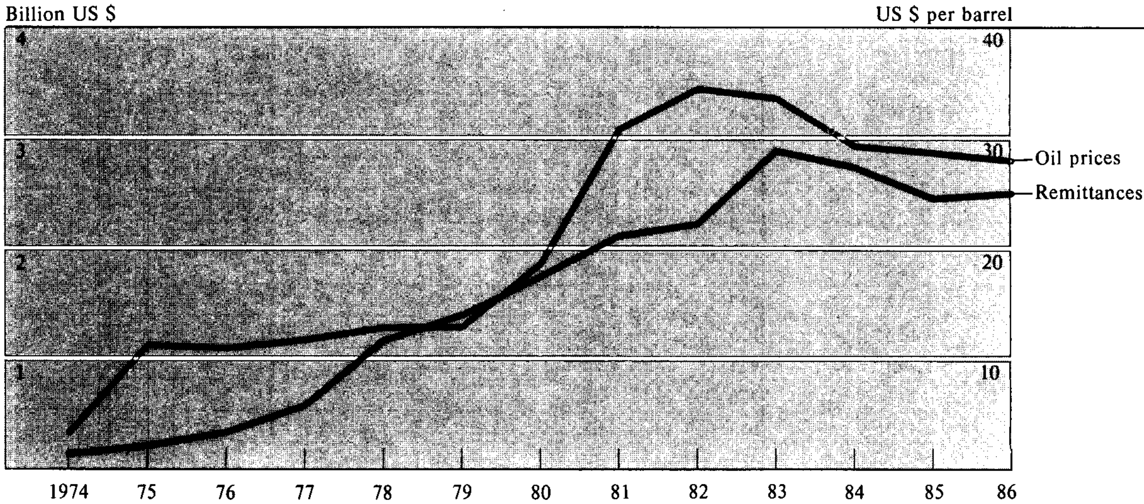
Unbalanced Payments

Pakistan's recently improved external financial condition masks disturbing trends in foreign trade and payments. Over the past five years, the value of imports has consistently been twice as large as exports, leading to a chronic trade deficit. This imbalance has forced Pakistan to rely on large surpluses on services—largely worker remittances—to narrow the current account deficit. But the decline in world oil prices has caused worker remittances to fall while interest payments have risen. [redacted] 25X1 25X1

Exports

Export growth, in value terms, has been sluggish. Exports in FY 1985 were only about 6 percent higher than in FY 1980. Rice and cotton, Pakistan's major

Figure 2
Pakistan: Remittances and Average OPEC Oil Prices, 1974-86



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agricultural exports, face glutted markets, declining world prices, and stiff international competition. Earnings from these crops dropped from a peak of $1.1 billion in FY 1981 to an estimated $670 million this fiscal year. [redacted] textiles, the major manufactured export, have performed well—buoyed by a near doubling of garment earnings—but have not been sufficient to offset the drop in farm exports. [redacted]

Imports

Since FY 1980, Pakistan's imports have grown in value terms at an average annual rate of about 4 percent. Much of the growth has been in petroleum products, cooking oils, and military hardware. Even though Pakistan's oil production has increased—it now meets about 33 percent of domestic needs—petroleum imports will probably be about $1 billion this year because Pakistan will not be able readily to renegotiate higher priced long-term contracts. Increased defense spending—and renewed US military aid—has caused defense imports to increase more than 40 percent since FY 1980, according to Embassy reporting. Subsidized prices and rising incomes have caused Pakistan's cooking oil imports to double in value terms since FY 1980. [redacted] 25X1

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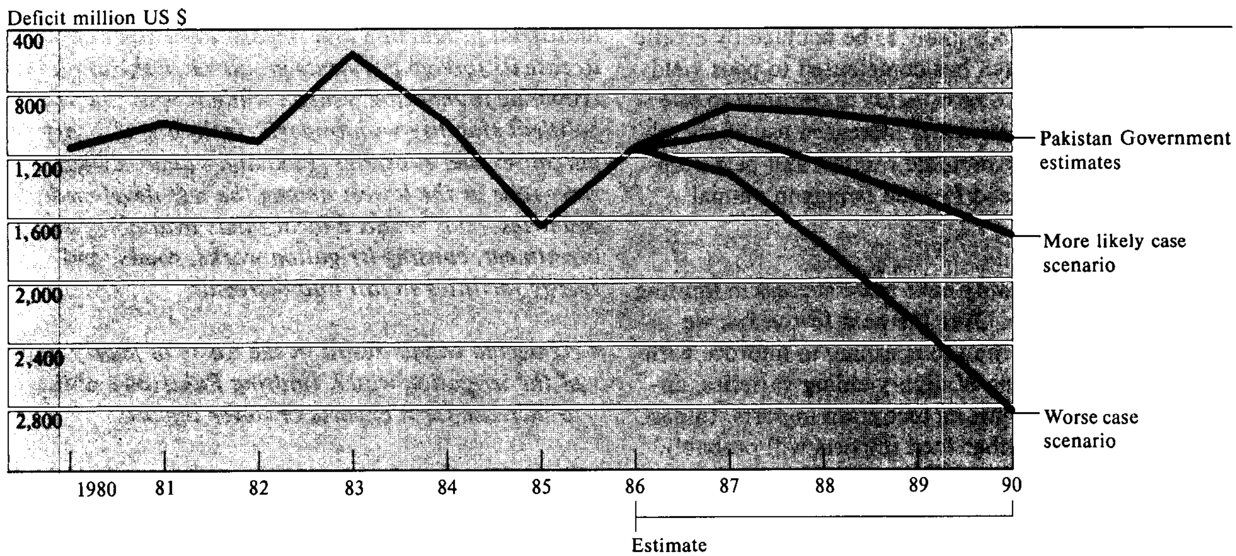
Remittances

Pakistan has depended on worker remittances to help cover its chronic trade deficit. Remittances peaked at $2.9 billion in FY 1983, [redacted] 25X1
The majority of these remittances come from workers in the Gulf states. The slowdown in Gulf economic activity because of falling world oil prices has led to a 15-percent drop in these earnings since FY 1983.
[redacted] 25X1

Debt

Pakistan's foreign payments position has been eroded by a rising foreign debt service burden. Although most of Pakistan's debt is on concessional terms,

Figure 3
Pakistan: Current Account Deficit Forecasts



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principal and interest payments will total $1.1 billion this year, a nearly 50-percent increase over FY 1980. We estimate Pakistan's debt service ratio steadily increased from 6 percent of exports of goods and services in FY 1980 to 22 percent this year.[4]

Foreign Aid

Islamabad has relied on large infusions of foreign aid to cover its current account deficits and to finance economic development. Since FY 1980, Pakistan has received, on average, more than $1 billion a year in project and commodity disbursements from the United States, Saudi Arabia, and multilateral donors. Even so, Pakistan has only a thin foreign exchange cushion—equivalent to about two months of imports.

The provision of $4 billion in an aid package for FYs 1988-93 agreed to during recently concluded negotiations between Islamabad and Washington will ease Pakistan's foreign payments problems. Pakistan initially requested $6.5 billion—more than twice the $3.2 billion in the current package. The US Embassy reports that the new civilian government wanted a substantial increase to buttress Pakistan's fledgling democracy, to provide for economic support necessary to build a domestic constituency, and to dampen criticism. 25X1

Foreign Payments Outlook

Despite recent improvement, Islamabad's foreign payments situation is likely to deteriorate over the next five years. Although increased food production and lower cost petroleum, cooking oil, and raw materials will help contain the import bill, Pakistan's agriculture-based exports will face depressed prices and shrinking markets. In addition, declining worker remittances and a growing debt service burden will worsen Pakistan's foreign payments position. 25X1

[4] Many international bankers believe that a debt service ratio higher than 20 percent is worrisome. 25X1

Agricultural Trade

We believe Pakistan will have a difficult time increasing farm exports. Earnings from rice and cotton are likely to be limited by low prices and glutted markets in the face of continued stiff international competition. Rice production is likely to be hobbled by erratic canal irrigation, which has contributed to poor yields. Although we expect cotton yields to continue to rise—spurred by new varieties and increased use of chemical fertilizers—unpredictable rainfall and pest problems will probably lead to wide swings in annual production. [redacted]

Islamabad will probably have more success in limiting agricultural imports. Over the next few years, we expect wheat production to continue to improve with the increased planting of high-yielding varieties, enabling Pakistan to limit its foodgrain imports. Imported cooking oil and other food imports will probably also be cheaper because of depressed world markets. The recent deregulation of the cooking oil industry could lead to increased oilseed production and slower import growth. [redacted]

Even though Islamabad has begun to revise its agricultural policies to stimulate production, we believe these efforts will fall short of goals. Procurement prices for wheat, oilseeds, and rice have been increased by an average of 10 percent over last year. The FY 1986 budget contains a 34-percent increase for irrigation and agriculture, with incentives for the import of farm implements and irrigation pumps. We judge that these are steps in the right direction, but sustained improvements in productivity will probably require an even greater commitment to higher domestic commodity prices, more farm input subsidies—fertilizers and pesticides—and investment in water control, agricultural research, and extension. [redacted]

Manufactures

Exports of manufactured goods, in our view, are not likely to increase much beyond historical growth rates because of restrictive foreign import quotas, international competition, and the generally poor quality and high cost of Pakistani goods. Overstaffing and outdated equipment in Pakistan's large-scale textile mills will mean high-cost yarn and cloth, impeding export growth. With more than half of loom capacity lying idle, the volume of cloth exports grew by a relatively modest 5 percent in the first half of this fiscal year, according to Embassy reporting. [redacted] 25X1

Because other manufactured exports suffer from high costs and shoddy workmanship, they are not likely to perform well either. We expect Pakistan to maintain high import duties, providing greater incentives to produce for the domestic market rather than for export. [redacted] perennial inefficiencies in Pakistan's public-sector industries, which supply the bulk of industrial raw and semifinished materials, will keep production costs high and will lower export competitiveness. [redacted]

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Structural Weakness

Over the next few years, a dilapidated economic infrastructure is likely to disrupt agricultural and industrial production and impede Pakistan's efforts to ease its foreign payments problems. Pakistan let its economic foundation weaken while it was "buying" political stability with imports, including military purchases and subsidies. Pakistan's poor savings rate—one of the lowest among the less developed countries—has reduced local funds available for investment, causing irrigation works, roads, and energy facilities to fall into disrepair: 25X1

- *Neglected canals result in the waste of nearly half of the irrigation water, limiting Pakistan's ability to increase farm exports or lower imports.*
- *Persistent electrical power shortages resulting from inadequate investment, management, and maintenance have disrupted agricultural and industrial production and increased petroleum imports.* 25X1
- *Poor maintenance and a lack of rolling stock and locomotives have led to a 10-percent annual decline in rail transport and an increased use of road transport. Pakistan's dilapidated rail and road systems are likely to increase transport costs, cause bottlenecks, and stifle rapid export growth.* [redacted] 25X1

Other Imports

Because Pakistan is unlikely to increase exports markedly, we judge Islamabad will have to limit import growth to reduce its current account deficit. Consumer goods and some raw materials—an estimated 30 percent of total imports in FY 1985—are likely to be targeted for cuts. Press reports indicate that Islamabad has tightened credit for raw material importers, is charging a premium on imported engineering goods, and is considering a ban on foreign car imports. Pakistan will benefit from depressed world commodity prices, which will reduce raw material import costs. [redacted]

We believe that lower oil prices will help Pakistan contain its oil import bill. [redacted] Pakistan could shave $260 million off its FY 1986 petroleum bill if oil prices remain at $15 a barrel. Some of the gains from lower world oil prices will probably be eroded over the next few years, however, as domestic petroleum consumption increases. [redacted]

If world oil prices remain low for an extended period, Pakistan is almost certain to experience a sharp reduction in worker remittances, with a net negative effect on Pakistan's foreign payments. The historical relationship between remittances and oil prices indicates that, with every $1 decline in the price of oil, Pakistan's remittance earnings are likely to fall by $90 million within two years. If this relationship holds, oil prices of $15 a barrel could reduce Pakistan's remittance earnings to about $1.6 billion by FY 1988—a 56-percent drop from FY 1986—as workers are repatriated and the wages of those who remain are cut. [redacted] 25X1

Debt Burden

We expect that Pakistan's debt burden will grow over the next few years and foreign exchange reserves will remain low, and that Islamabad therefore may well seek a debt rescheduling or an IMF standby agreement within the next year or two. Interest and principal repayment on previous borrowings, military purchases under the US Foreign Military Sales (FMS) program, and IMF loans will raise Pakistan's debt burden to an estimated $1.8 billion—about $450 million to the United States alone—by FY 1990. Even under Islamabad's optimistic export assumptions, the debt service ratio would rise to 26 percent. [redacted]

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Table 2
Pakistan: The Government's Foreign Payments Estimates

Million US $

	FY 1986 [a]	FY 1987 [b]	FY 1988 [b]	FY 1989 [b]	FY 1990 [b]
Trade balance	−3,050	−2,745	−2,710	−2,721	−2,721
Exports (f.o.b.)	2,945	3,335	3,735	4,109	4,519
Imports (f.o.b.)	5,995	6,080	6,445	6,830	7,240
Services balance	1,679	1,620	1,538	1,460	1,364
Of which:					
Interest payments	429	478	469	456	457
Remittances	2,520	2,500	2,450	2,400	2,350
Private transfers	223	230	240	250	260
Current account	−1,148	−895	−932	−1,011	−1,097

[a] Estimated.
[b] Projected.

[redacted] 25X1

Table 3
Pakistan: The Government's Financial Gap Estimates

Million US $

	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Current account	−1,148	−895	−932	−1,011	−1,097
Principal amortization payments	582	725	835	734	708
FMS payments [a]	124	169	238	262	298
Financial gap	1,854	1,789	2,005	2,007	2,103

[a] FMS 100 percent concessional.

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Table 4
Pakistan: A Worse Case Foreign Payments Scenario

Million US $

	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Trade balance	−3,050	−3,392	−3,763	−4,166	−4,604
Exports (f.o.b.)	2,850	2,951	3,055	3,164	3,275
Imports (f.o.b.)	5,900	6,343	6,818	7,330	7,879
Services balance	1,675	1,897	1,787	1,687	1,579
Of which:					
Interest payments	429	478	469	456	457
Remittances	2,500	2,375	2,256	2,143	2,036
Private transfers	219	179	200	200	200
Current account	−1,156	−1,316	−1,776	−2,279	−2,825

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Foreign Payments and Financial Gap Scenarios

Islamabad's Scenario

Islamabad's foreign payments projections show a fairly stable current account deficit. The Pakistanis assume that export earnings will increase at an average annual rate of 11 percent and imports at nearly 3 percent, and remittances will decline at about 2 percent per year. Under these assumptions, the current account deficit would reach $1.1 billion in FY 1990. Adding principal, interest, and FMS payments obligations would give a financial gap of $2.1 billion.

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A Worse Case Scenario

If exports grow at an average annual rate of only 3.5 percent—limited by glutted markets and low commodity prices—imports grow by 7.5 percent to keep consumers happy, and remittance earnings decline at an annual rate of 5 percent, Pakistan's foreign payments situation would deteriorate considerably. Under these assumptions, Pakistan's current account deficit could top $2.8 billion, with a financial gap of $3.8 billion, by FY 1990.

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Table 5
Pakistan: A Worse Case Financial Gap Scenario

Million US $

	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Current account	−1,156	−1,316	−1,776	−2,279	−2,825
Prinicpal amortization payments	582	725	835	734	708
FMS payments [a]	124	169	238	262	298
Financial gap	1,862	2,210	2,849	3,275	3,831

[a] FMS 100 percent concessional.

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Table 6
Pakistan: A More Likely Foreign Payments Scenario

Million US $

	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Trade balance	−3,050	−3,214	−3,386	−3,567	−3,757
Exports (f.o.b.)	2,850	2,950	3,053	3,160	3,270
Imports (f.o.b.)	5,900	6,164	6,439	6,727	7,028
Services balance	1,675	1,972	1,932	1,897	1,849
Of which:					
Interest payments	429	478	469	456	457
Remittances	2,500	2,450	2,401	2,353	2,306
Private tranfers	219	179	200	200	200
Current account	−1,156	−1,063	−1,254	−1,470	−1,708

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A More Likely Scenario

We judge that exports are not likely to grow as fast as Islamabad expects, but lower oil and commodity prices and policies designed to reduce import growth will help contain Pakistan's trade deficit. With import and export growth rates of roughly 4 percent annually and remittance earnings declining by 2 percent per year, Pakistan's current account deficit could be held to $1.7 billion by FY 1990, one and a half times government projections. Pakistan's financial gap would be $2.7 billion.

Implications for Domestic Political Stability

The currently healthy economy gives the new civilian government some breathing room on the economic front. It also provides Islamabad with an excuse to defer economic policy changes recommended by the IMF and Washington, such as currency devaluation, tax reform, and spending cuts. Because IMF loan conditions usually require economic policy changes such as currency devaluation and budget deficit reductions, we judge Islamabad will use the temporary reprieve to avoid negotiating a standby agreement.

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Table 7
Pakistan: A More Likely Financial Gap Scenario

Million US $

	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Current account	−1.156	−1,063	−1,254	−1,470	−1,708
Principal amortization payments	582	725	835	734	708
FMS payments [a]	124	169	238	262	298
Financial gap	1,862	1,957	2,327	2,466	2,714

[a] FMS 100 percent concessional.

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Because the new civilian government is unlikely to enjoy the same economic luck that Zia experienced during the period of martial law, we believe it will have to introduce a tough austerity program before the election scheduled for 1990. The civilian government will probably approach the problem by adopting restrictive economic policies in piecemeal fashion. The Junejo regime will probably move to reduce domestic budget deficits through subsidy reductions and deregulation, while lowering the trade gap by cutting back nonessential imports. Islamabad, however, will resist more politically contentious issues such as currency devaluation or tax reform.

Although Prime Minister Junejo has promised increased spending on education, health, and agriculture—in hopes of improving his political fortunes—these economic and political goals will be difficult to achieve. The bulk of economic aid from the United States will go to either debt servicing or commodity support, thereby limiting new funds available for development projects. Under these circumstances, increased development spending would require reordering budgetary priorities and increasing taxes, moves likely to be strongly opposed by Pakistan's powerful military, rural landlords, and business community.

Austerity measures of the magnitude we believe necessary to contain Pakistan's foreign payments problem will slow economic growth and provide issues for aspiring politicians. An austerity-induced economic downturn will favor the populist-oriented opposition Pakistan People's Party (PPP) led by Benazir Bhutto. These conditions will probably help the PPP strengthen its traditional constituency among disfranchised groups, such as students, labor, urban poor, and small farmers, whose interests were neglected under military rule. Moreover, a rapid return of unemployed expatriate workers to the Pakistani labor market will add to the PPP's ranks and increase the possibility of political unrest. 25X1

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Implications for the United States

As Pakistan's foreign exchange situation deteriorates, we expect Islamabad will put increasing pressure on Washington to provide a bailout. At a minimum, we believe Pakistani officials will press the United States to intervene with the IMF for less restrictive policy conditions in return for a standby loan agreement. They are also likely to request forgiveness of or rescheduling on outstanding FMS obligations and grants on new disbursements. 25X1

We believe Islamabad's initial $6.5 billion request for the FYs 1988-93 package was, in part, an effort to lay the groundwork for blaming Washington should Pakistan run into serious foreign exchange problems and have to impose unpopular austerity measures. The greater the new civilian government's financial

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problems, the more it is likely to focus on domestic economic issues rather than foreign policy questions. For example, Islamabad could be more accommodating on a peace settlement in Afghanistan in an effort to force the repatriation of nearly 3 million refugees and ease the burden on the economy. Economic problems would make Islamabad reluctant to risk expanded trade relations with India, thereby circumscribing recent efforts at rapprochement. 25X1

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